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In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

CAROL SMITH SHANNON and PHILIP A. TOFT,
Petitioners,

vs.

FRED H. HARMSEN, et al.,
Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED FOR PREVIEW

1. Whether the Ninth Circuit properly determined that the National Bank Act and the federal securities laws both provide remedies for improper nondisclosures relating to the purchase of bank stock.

2. Whether the Ninth Circuit properly determined that the class certification procedures followed by the trial court were not improper and that plaintiffs have standing to sue.

3. Whether the Ninth Circuit properly applied standards for determination of secondary liability under Section 10(b) which are entirely consistent with, and in some instances more stringent than, standards set out in prior case law.

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Respondents, plaintiffs below, respectfully urge this Court to deny the petition of Carol Smith Shannon ("Shannon") and Philip A. Toft ("Toft") for writ of certiorari. These petitioners point to no conflict between the decision of the Ninth Circuit in this case and the decisions of this Court or of any other circuit courts. Nor do petitioners demonstrate any impropriety in the Ninth Circuit's resolution of the issues before it.

I

STATEMENT OF THE CASE

This petition is brought by Carol Smith Shannon, daughter of co-defendant C. Arnholt Smith,[1] and Philip A. Toft, a close business associate of Mr. Smith. Both Shannon and Toft were found liable for aider/abettor liability and conspiracy liability under Section 10(b) of the Securities Exchange Act of 1934, and fraud, conspiracy to defraud and conspiracy to abuse control under California state law principles. In addition, Shannon was found liable for control person liability under Section 20(a) of the '34 Act.

The facts which were presented to the jury arise out of the operation and collapse of United States National Bank on October 18, 1973 and the direct loss to the shareholders of the bank. As petitioners concede, C. Arnholt Smith controlled USNB from 1933 until 1973. When the bank collapsed in 1973, USNB had between $150 and $200 million in uncollectible loans (RT 2235-37). The background of USNB and how it was used by the defendants collectively is set out in respondents' Brief in Opposition to Helen Smith's Petition for Writ of Certiorari (No. 82-1980) and, for the sake of brevity, will not be repeated here.

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[1]C. Arnholt Smith was and is represented by the same counsel as Shannon and Toft. The petition virtually admits the very violations alleged against C. Arnholt Smith (Petition, p. 3), although at trial he exercised his right to remain silent pursuant to the Fifth Amendment to the U.S. Constitution. C. Arnholt did not petition to this Court for relief, although the exclusivity of the National Bank Act is an argument that affects only him directly. As a threshold issue, this Court may find it inappropriate to consider the issues raised by these petitioners because the individual most directly affected has not chosen to seek review.

The roles played by Shannon and Toft will be summarized below.

A. Role of Carol Smith Shannon

Petitioners concede that Carol Smith Shannon diverted loan proceeds from one Smith-controlled entity to another, acting in concert with C. Arnholt Smith. Petition, p. 3. Petitioners fail, however, to mention the many other self-dealing and/or self-enriching transactions Shannon engaged in at the expense of the Bank and its shareholders. These other activities demonstrated her *scienter* and cemented her liability.

(1) Corporate Director of Controlled Entities

Carol Smith Shannon sat on the Board of Directors of Westgate California Corp. ("Westgate" or "WCC") and attended its meetings. (RT 4979) During her tenure on the Board, WCC was the recipient of millions of dollars of USNB loan funds that were never recorded on Westgate's books. (RT 4214-4215)

Shannon also sat on the Board of Directors of Air California, a Westgate subsidiary. (RT 4983-84). During her time on that Board, approximately $4 million in credit was illegally shifted to British Columbia Investment Company ("BCIC"; see p. 1, EXH. 169 and 170), a company which, as noted earlier, eventually wound up owing USNB over $100 million in uncollectible funds. While Shannon denied all knowledge of these illicit transfers (RT 4988), the jury concluded otherwise from all the evidence of her involvement.

Shannon was also a director of U.S. Holding Co., a Smith family owned entity (RT 4980). Thousands of dollars of loan proceeds were directed to this company (EXH. 191).

(2) Loan Transactions with USNB

Shannon was involved in self-dealing and fraudulent debt rollovers through her sole ownership of Valley Lane Farms, Inc. (VLF). VLF was established in 1969 or 1970 with a $300,000 real estate loan from USNB, negotiated by Shannon's father. (RT 4966-67; 4976-77) Shannon's company, VLF, was the sole owner of United City, Inc. (RT 5027), Vista San Luis Rey (RT 5020), South Coast Financial Corp. (RT 5021), Underwriters' Insurance Agency (RT 5042) and other subsidiaries. At trial, Shannon testified that some of VLF's subsidiaries were merely "corporate shells." (RT 5022)

Both VLF and its subsidiaries were involved in numerous fraudulent transactions with USNB. For example, in 1972 Westgate California Realty, Inc. and Wescal Properties, Inc. were the collective recipients of $8,600,000 of USNB funds, ostensibly loaned for the purpose of rewriting existing debts and providing working capital. These funds were secretly deposited in Westgate Plaza Cash Collateral Account #3, set up by C.A. Smith and Philip Toft. The money was then diverted to various other entities, with VLF receiving a total of $42,000. The FDIC estimates that more than $4 million of these funds are uncollectible (Exh. 191-50; 191-56).

In 1971, United City, Inc., a VLF entity, retired an existing $1,617,000 obligation to USNB with funds provided by Sovereign State Capital ("SSC"). (Exh. 191-61.) The

source of much of SSC's funds was a USNB loan to Wescal, which had been remitted to SSC by Philip Toft. (*Id.*) The effect of this transaction was to allow United City, Inc. to retire an existing obligation to USNB with funds obtained from the bank itself—a flagrant debt rollover. Since Shannon was the *sole owner* of United City, Inc., the jury could reasonably have inferred her knowledge of this transaction.

In addition to benefitting directly from USNB loans, Shannon's subsidiaries also served as a conduit for illicit loan transfers themselves. On June 4, 1969, C.A. Smith approved a $350,000 unsecured loan to Shannon's wholly-owned Underwriters' Insurance Agency (UIA) (RT 2291-92; Exh. 191-74). Although there was no indication on the bank records that the loan would be used by entities other than UIA (RT 2295), Shannon's company immediately transferred the money to Sovereign State Capital, a Smith family corporation (Exh. 191-74).

Beyond participating as a corporate director and through her own companies in the USNB loans, Shannon was also personally involved in conduit loan transactions. At trial, it was shown that she served as a willing conduit (to use her own words, a "nominee"; RT 5004) for the secret transfer of $150,000 from National Marine Terminals, Inc. (NMT)[2] to First California Corp., which was owned by M.J. Coen (RT 5006). Although Shannon denied any personal involvement in the transaction, she did admit knowledge of the scheme under which NMT issued a $150,000

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[2]NMT was a Smith family entity, a subsidiary of SSC. At the time of the bank examiner's report in 1972, NMT owed $5,143,225 to USNB (Exh. 170, page 2-A-1).

loan to Shannon, who then remitted the balance to First California. (RT 5002-5006)

(3) Personal Benefits from USNB

Shannon also derived personal benefit from her association with USNB. One such example was in 1971, when she acquired through VLF approximately 160 acres of orange groves from Calafia Land Corporation, in return for a promissory note in the amount of $750,000. (RT 5030-31; Exh. 434). *Eleven* days later, this note was transferred to USNB and booked in Shannon's name for only $500,000. (RT 2241). The result of this transaction was to reduce Shannon's debt immediately from $750,000 to $500,000—an outright gift of $250,000. Moreover, Shannon paid only $50,000 to the bank on the debt and has made no further payments. (RT 2241-43; 5035-38; Exh. 435) The land is still in her name and is now worth over $1 million (RT 5087).

Shannon's primary valuable asset, besides her various corporations, is Valley Lane Farms. Having bought this on a $300,000 loan from USNB through C.A. Smith in 1969, Shannon sold 17 or 18 acres out of a total of 60 for $1,450,000 (CR 8540). Shannon estimates the value of the remaining 42 acres to be $3 or $4 million dollars (RT 8541). This does not include the assets in other corporations owned by Shannon. Her companies were recipients of millions of dollars of loans, all undisclosed to the shareholders of USNB and now uncollectible. (Exh. 191; 119).

None of these improper activities was disclosed to the shareholders (Exh. 119).

B. Role of Philip A. Toft

Toft joined WCC in 1962 as Vice-President of Finance and rose through the ranks until he was named President of WCC in 1972 (RT 5241-44). Toft was personally involved in the administration of the financial affairs of WCC from 1962 until the time of WCC's bankruptcy. He was a director of all of WCC's subsidiaries (RT 5245). At trial, Toft testified that he assisted C.A. Smith in setting up the secret "cash collateral" or "administrative" accounts which were used to funnel loans to entities other than those named on bank records. (RT 5253; 5276-77). Indeed, many of the illicit loan transfers bore Toft's own personal signature. (Exh. 191) The extent of Toft's intimate involvement in the fraud was established by bank attorney Hugh Friedman, who testified that, in 1973, he was called into C.A. Smith's office where both Toft and C.A. Smith candidly admitted that they had been taking loans in the name of Westgate subsidiaries without bothering to disclose the transactions on the corporation's own books. (RT 4954, 4961-62).

The jury found against Toft on all counts which involved his acting in concert with C.A. Smith. During proceedings before the Ninth Circuit, Toft virtually admitted his liability. At page 13 of his Opening Brief on Appeal, he stated:

> In 1968 Toft was an officer and director of Westgate which Smith controlled. Subsequent to March 1, 1968, Toft at Smith's suggestion secured loans for Westgate's subsidiaries. On some occasions at Smith's suggestion the money was not used for the purpose stated in the loan application but was reloaned to another Smith controlled entity.

C. Conclusion

Petitioners' arguments in the instant proceedings must be considered in the context of the facts established at trial and admitted by petitioners in this Court. In essence, petitioners' primary theory in this Court is that they should be immune from liability under the federal securities laws, because the National Bank Act provides a limited remedy not against them, but against some *other* defendants. The Ninth Circuit properly rejected this claim.

II

REASONS REVIEW SHOULD BE DENIED

A. The Ninth Circuit's Analysis of the National Bank Act Is Consistent with Prior Decisions of This Court

This Court has held that the National Bank Act provides a limited private remedy against the directors of a national bank. *Chesbrough v. Woodworth,* 244 U.S. 72, 76 (1917). These actions, under Section 93 of the Act, are limited to violations of "any of the provisions of" Chapter 2, Title 12 of the U.S. Code (Banks and Banking) and may only be brought against directors of the Bank.

Petitioners Shannon and Toft argue that the National Bank Act remedy is exclusive of all other remedies against directors and non-directors alike:

> **Having employed the exclusive remedy available against the bank directors, the lower court was without jurisdiction to entertain an action by the plaintiffs against any of the non-director defendants, such as Shannon and Toft, under the federal securities laws or pendent state claims based upon the same alleged activities. (Petition, p. 10)**

They thus claim complete immunity for themselves, based upon the availability of a limited remedy against others. The Ninth Circuit correctly rejected this unprecedented position.[3]

The Court first discussed the relationship between liability under the National Bank Act and pendent state law claims. *Harmsen v. Smith,* 693 F.2d 932, 939 (9th Cir. 1982), attached as Appendix "A" to Petition, p. 8. The Court noted that C. Arnholt Smith (a bank director) could only be liable for pendent state claims "based on conduct outside the reach of the Bank Act" (Appendix "A", p.9), citing *Yates v. Jones National Bank,* 206 U.S. 158 (1907). The Ninth Circuit found that the pendent claims did, as a matter of fact, involve claims outside the scope of Section 93:

> The complaint alleges, and the record clearly shows that C. Arnholt was engaged in fraudulent activity that went far beyond the narrow range of conduct prohibited by the Act. The district court judge specifically so held in his denial of defendants' motion for judgment n.o.v., and we agree. We thus conclude that the district court acted properly in considering the pendent claims against C. Arnholt. (Appendix "A", p.9)

The Ninth Circuit next considered the question "whether section 93 of the National Bank Act restricts our ability to consider the section 10(b) claims." Appendix "A", p. 10. The Court correctly concluded it does not.

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[3]Interestingly, C. Arnholt Smith, the one defendant directly affected by the National Bank Act and thus the one person primarily concerned with the inter-relationship between that Act and the federal securities laws, has not petitioned this Court for relief.

The Court reasoned that allowing a section 10(b) claim would not subject bank directors to varying standards of liability from state to state, the concern in *Yates*. Nor did Congress exclude banks from the coverage of section 10(b), although it did provide specific exemptions for banks from other provisions of the securities laws. Because there is no conflict between the two statutes, statutory construction requires that each be regarded as effective. *Morton v. Manchri*, 417 U.S. 535, 551 (1974). Finally, this Court's decision in *Radzanower v. Touche, Ross & Co.*, 426 U.S. 148 (1976) is consistent with the conclusion that the federal securities laws do apply to national banks.

Petitioners cite to no decisions, by this Court or by other circuits, which suggest that securities claims against bank directors are foreclosed by the existence of the National Bank Act. Rather, they merely attempt to graft the "exclusivity" language applicable only to pendent common law claims under *Yates*, on to the separate body of federal securities laws. As the Ninth Circuit determined, petitioners' position is inconsistent with prior case law. Moreover, the ultimate result of Petitioner's argument would be to read § 10(b) out of the statute books in any case involving bank securities. Under this reasoning, if any bank director is liable under Section 93 of the National Bank Act, then *no one else* can be held for responsible for aiding and abetting or conspiracy to violate § 10(b). In particular, Carol Shannon and Phil Toft would be immune from suit, no matter how egregious their conduct, so long as C.A. Smith violated the National Bank Act. Such a result is preposterous.

The Ninth Circuit harmonized the statutes and avoided the inherently untenable conclusion urged by petitioners. Nothing in the decision is at odds with any decision of this Court or of other circuits. No review is necessary.

B. The Ninth Circuit Properly Assessed the Class Certification and Standing Issues

Petitioners Shannon and Toft argue here, as they argued in the Ninth Circuit, that the trial court's failure to certify a specific, formal purchaser subclass was improper; and further that plaintiffs lacked standing because they failed to prevail on the merits as to certain time periods. These arguments were properly rejected by the Ninth Circuit, and raise no issues meriting review by this Court.

(1) Class Certification Does Not Require Review

Petitioners argue that by allowing the class certified under § 93 of the National Bank Act to function simultaneously as the plaintiff class in the securities fraud claim, the trial judge in effect created a 10(b) class whose membership was broad enough to include actual shareholders, in addition to purchasers and sellers of USNB stock. Except for the bald assertion that this action demonstrated the trial court's lack of "regard . . . for the key language in § 10(b)" (Petition, p. 16), petitioners meticulously avoid stating their precise objection to the class delineation. In fact, an examination of the trial record demonstrates the court's ongoing adherence to the mandate of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 729 (1975). As early as the Pretrial Order, the trial court carefully distinguished the issues to be addressed under the respective claims, noting that the principal question to be resolved

by members of the § 10(b) class was "(w)hether under Rule 10b-5 the alleged misrepresentations and omissions were made 'in connection with' the purchase or sale of USNB securities." (CR 1036). Later in instructing the jury on the 10(b) count, the trial judge explicitly noted that a requirement for finding liability was that "the defendants used the mails *in connection with the purchase or sale of securities.*" (RT 7081; Emphasis added). Finally, in his instructions at the conclusion of the damage phase, the trial court directed the jury that:

> The plaintiff is required to prove, by a fair preponderance of the evidence, that he or she suffered damages as a proximate result of the alleged misleading statements or missions, *and the purchase of stock in reliance on that.* (RT 9995; emphasis added)

Nothing in the trial record suggests that the handling of the 10(b) claims resulted in injury to the defendants' interests. While class members with 10(b) claims represented a well-defined sub-group of the class as certified, there was neither antagonism nor conflict between those class members and the National Bank Act "holders." The Ninth Circuit agreed, and specifically found:

> Given the district court's specific and unambiguous instructions to the jury that only purchasers of stock could recover, appellants did not suffer any prejudice because the trial court failed formally to certify a subclass of purchasers. (Appendix "A", p. 15)

(2) Plaintiffs Below Had Standing to Sue Shannon and Toft

The sole basis for petitioners' claim that plaintiffs lacked standing to sue is that "Shannon and Toft's alleged liability was found by the jury to have started after the class rep-

resentatives had purchased their stock." Petition, p. 17. This hindsight reasoning contradicts fundamental jurisdictional concepts.

The Ninth Circuit quite properly rejected this argument. See Appendix "A" to Petition, pp. 16-17:

> These plaintiffs had standing to pursue the action in the first instance. Standing ordinarily does not depend upon the merits of a plaintiff's contentions; the requirement is based upon a separate determination that the plaintiffs have made "allegations of demonstrable, particularlized injury." *Warth v. Seldin,* 422 U.S. 490, 508, 95 S.Ct. 2197, 2210 (1975).

There is no reason to review the Ninth Circuit's determination.

C. The Ninth Circuit's Analysis of Secondary Liability Is Correct and Consistent with Prior Cases from This Court

Petitioners Shannon and Toft raise the same arguments concerning secondary liability under Section 10(b) as are raised in the petition for writ of certiorari filed by Helen Smith in this case (No. 82-1980). This Court is respectfully referred to respondents' Brief in Opposition to Helen Smith's petition, Section II (B), pp. 14-16.

In summary, the test applied by the Ninth Circuit was, if anything, more stringent than the Second Circuit standards outlined in *ITT, An International Investment Trust v. Cornfeld,* 619 F.2d 909, 922 (2d Cir. 1980). The Court found that Shannon and Toft had actual knowledge of C. Arnholt Smith's primary violations and of their roles in furthering them. The Ninth Circuit found the holding in *Chiarella v.*

U.S., 445 U.S. 222 (1980) inapplicable, since the duty of a secondary violator arises from knowing assistance of or participation in a fraudulent scheme. The Court found as a fact that:

> The record clearly shows that the jury was presented with sufficient evidence surrounding transactions involving both Shannon and Toft from which it could find knowing assistance or participation. (Appendix "A", p. 17)

No review by this Court is required.

CONCLUSION

The judgments against Shannon and Toft were fairly obtained and fairly reviewed. Nothing in the Ninth Circuit's opinion is contrary to prior decisions of this Court or of the other circuits. It is respectfully requested that the petition be denied.

Dated: July 6, 1983

Respectfully submitted,

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